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World Natural Rubber Prospects: A Case Study of LDC Commodity Problems

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An Intelligence Assessment

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*GI 84-10011
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An Intelligence Assessment

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Key Judgments

*Information available
as of December 1983
was used in this report.*

In many ways the plight of the natural rubber industry represents in microcosm the problems many less developed countries (LDCs) are or will be facing on the commodity front. As with many basic raw materials, Third World rubber producers have been buffeted both by technological advances and by changing market demand:

- Markets are being eroded substantially by new technology. Synthetic rubber, developed during World War II, now accounts for 70 percent of the overall rubber market. Sugar, cotton, copper, and tropical timber are increasingly facing this challenge.
- Shifting demand, caused by energy conservation efforts and changing tastes, has reduced markets. The downsizing of cars, increased use of mass transit, and longer wearing tires are cutting back natural rubber use. Similar consumption shifts are hurting demand for other commodities such as coffee and tin.

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Natural rubber producers as a group have, to date, been unable to develop a viable approach to meet these challenges. Rather than finding ways to adjust to market conditions, they have:

- Generally pushed toward greater production in an already glutted market.
- Pressed on the international front for price and export controls administered through international commodity agreements.

So far, this type of strategy has failed to solve the problems that LDC producers face.

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Nevertheless, commodity-dependent LDCs across the board will continue to press the United States for:

- Greater financial help in the form of short-term credits, long-term development loans, a greater US sharing of buffer stock financing, and purchases at subsidized prices.
- Wider access to US markets, on a preferential basis if possible.
- Greater use of international commodity agreements, citing US and European Community tendencies to impose protectionist measures to the LDCs' relative disadvantage.

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US policymakers will have to weigh the short-term gains of such concessions against their longer run impact. While greater support for multilateral commodity agreements may temporarily ease LDC earnings problems, such actions, unless coupled with realistic adjustment policies, run the risk of perpetuating the basic problem of most commodities—excessive production. Eventually, the LDCs will have to begin restructuring their economies away from basic commodities and raw materials. In that event, requests by LDCs for development loans and market access could provide the United States with opportunities for influencing the direction of change.

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The Backdrop

A key factor behind the problems of the debt-troubled less developed countries (LDCs) has been the falloff in their export earnings caused by the recession in Organization for Economic Cooperation and Development (OECD) countries. The steep slide in nonfuel commodity prices—the most severe and prolonged since World War II—together with sizable declines in export volumes, severely crimped revenues. Among key LDC debtors, nonfuel commodities account for as much as 80 percent of total export earnings.

Evidence that the US recovery was under way sparked a rally in commodity prices early in 1983. *The Economist's* price index of industrial materials by August jumped 20 percent, as compared to December of the previous year. Many individual commodities performed considerably better. Natural rubber prices, for example, advanced 40 percent. The price rise was touched off by speculators anticipating a strong surge in commodity demand such as that which had followed other recessions. Since August, however, prices have settled back, and prospects for an export turnaround on the commodity front are now considered poor at best by most trade sources. Agricultural surpluses are huge, and carryovers—especially for wheat, sugar, and coffee—will keep farm prices depressed.¹ As for raw materials, excess metals production capacity, large inventories, and changing demand patterns are likely to hold the price recovery below prerecession levels for many months.

How well LDCs do over the next several years will depend in part on the pace and magnitude of recovery in the severely depressed nonfuel commodity markets. While each of the dozens of individual commodities has its unique market problems, most share a wide

range of similar obstacles. To gain insight into the hurdles facing LDC commodities exporters, we have selected natural rubber for detailed analysis.

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Rubber: A Case Study

Natural rubber's difficulties are symptomatic of the problems facing most commodities. In the mid-1970s, industry experts predicted a great future for rubber because:

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- Skyrocketing oil prices would bring competition from synthetic rubber to heel. The market share of natural rubber in the United States—which had skidded downward for two decades—rose from 22.5 percent to 26.5 percent in the mid-1970s. Industry analysts predicted it would rise to 35 percent over the next decade.
- Giant strides being made in natural rubber production technology promised to boost yields by as much as 50 percent.
- The Association of Natural Rubber Producers was formed to share technical knowledge and marketing arrangements. Initial steps were taken to form an International Rubber Agreement under the UN Conference on Trade and Development (UNCTAD).
- Enormous surpluses that plagued other commodities such as copper and sugar were avoided by natural rubber producers. This offered the hope of a reasonable rate of return on investment.

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These prospects went largely unfulfilled. In the past few years, the outlook has soured. A key problem was the drop in demand and price caused by prolonged recession in the major OECD markets. From a record

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high of 80 cents per pound in 1980, rubber prices plunged nearly 50 percent by November 1982, severely crippling export earnings. []

While more than 95 percent of all natural rubber is produced in a handful of LDCs, not all natural rubber producers were equally hurt (see table). Thailand and Sri Lanka benefited from expansion projects that began in the late 1970s, which enabled some increases in export volumes. Even so:

- *Thailand's* earnings from natural rubber fell from 1980 to 1982 by nearly one-third to \$413 million even though sales volume grew nearly one-fifth.
- *Sri Lanka's* export earnings from natural rubber fell to \$112 million in 1982, 30 percent lower than the peak level reached in 1979. This occurred despite a 2-percent increase in sales volume. []

Other producers had to bear the full brunt of the recession:

- As compared with 1980, *Malaysia's* 1982 export earnings from natural rubber fell by \$983 million to \$1,137 million, the lowest level since 1975.
- *Indonesia's* sales of natural rubber brought in an estimated \$602 million in 1982, down more than \$560 million from the peak year of 1980.
- *Liberia's* estimated export earnings of \$50 million from natural rubber in 1982 were the lowest in nearly a decade. []

After previous recessions, exporters experienced a sharp rebound in shipments and prices. Producers may, however, be in for a major disappointment this time around. For example, the demand factors that caused the recent falloff in consumption seem likely to continue throughout the current recovery. Beyond 1983-84 the outlook for world economic growth is bearish. Wharton forecasters, for example, believe growth will average roughly 3 percent per year over the next decade, as compared with the 5.5-percent rate recorded from 1960 to 1973. For natural rubber, this slowdown in the global economy suggests a long-term demand growth rate of at best about 1.5 percent per year, less than half the 1961-79 average.² []

² Natural rubber producers cannot look to nonmarket economies as an outlet for increased sales. Examination of rubber trade statistics shows sharp declines in natural rubber imports by the USSR, Eastern Europe, and China over the past decade. These declines result from demand shifts toward synthetic rubber usage in all of these countries, as well as from a sharp increase in natural rubber production in China []

Selected LDCs: Rubber Export Earnings

Millions US \$

	Malaysia	Indonesia	Thailand	Sri Lanka	Liberia
1976	1,282	530	260	105	53
1977	1,373	588	302	102	59
1978	1,555	717	394	129	69
1979	2,048	937	605	160	88
1980	2,120	1,165	603	157	102
1981	1,611	828	497	150	89
1982	1,137	602	413	112	50 ^a

^a Estimated.

Source: "International Financial Statistics," *International Monetary Fund*, 1984.

Even if the rate of world economic growth and the demand for rubber by the transportation sector increase more than expected, natural rubber may not benefit because of two major roadblocks:

- Markets are being eroded substantially by new technology. If anything, competition from synthetic rubber, which already holds 70 percent of the rubber market, will intensify (see figure 1). Declining profit margins have forced synthetic rubber producers to become even more efficient, to pursue research and development of new production technologies, and to develop new products and markets.
- Shifting demand, caused by energy conservation efforts and changing tastes, has reduced markets. Because of the downsizing of cars, increased use of mass transit, and longer wearing tires, natural rubber use has been decreasing. []

Of these two factors, we believe the challenge from synthetics is more significant. Synthetic rubber producers are in a better position to expand output rapidly because nearly one-third of their capacity is unutilized at present, according to industry data. As long as oil prices remain relatively stable, prospects

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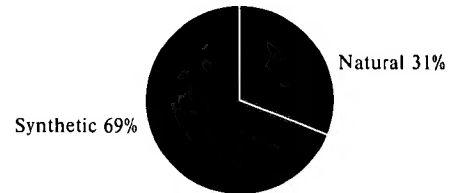
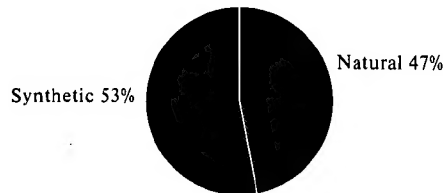
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Figure 1
Natural and Synthetic Rubber at a Glance

Market Shares: Natural and Synthetic Rubber

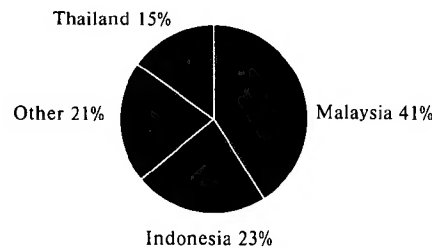
1960: 4.5 million metric tons

1980: 12.4 million metric tons



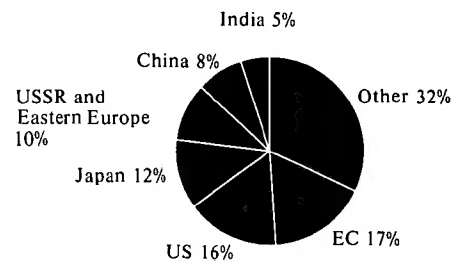
World Production, 1982 (Natural Rubber)

Total: 3.8 million metric tons



World Consumption, 1982 (Natural Rubber)

Total: 3.7 million metric tons



[Redacted]

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are bleak for natural rubber producers gaining any long-term price advantage that could reverse the shift toward greater usage of synthetic rubber. [Redacted]

Much of the past rapid rise in the share of synthetics occurred because natural rubber producers proved incapable of supplying global rubber demand increases in the 1970s of about 7 percent. It takes five to seven years from time of planting until rubber trees become productive. In contrast, industry statistics show that a synthetic rubber factory can be brought on stream in only two years. [Redacted]

Synthetic rubber producers are also helped by greater price stability. Natural rubber supply is very insensitive to price movements in the short term, causing prices to fluctuate widely whenever changes in economic activity induce even small shifts in demand. Natural rubber's price instability creates a great deal of uncertainty for manufacturers in terms of their production costs, discouraging its use. Moreover, backward integration by tiremakers into synthetic

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rubber production and forward integration by petrochemical producers into the same activity further encourage the production and consumption of synthetic rubber rather than natural rubber. []

Producer Response

Production

Natural rubber producers as a group have failed to develop a winning strategy to meet the rising tide of synthetic rubber in a stagnating market environment. While there have been some shifts from rubber to other tree crops such as palm oil, and, while investment funds have been harder to come by because of the debt situation, the natural rubber producers have generally stayed the course toward greater production. For example, during 1972-77 world natural rubber production grew at a 3-percent annual rate; much of the increase during the period resulted from investments in the late 1960s. With the exception of Thailand, however, investment in natural rubber since the early 1970s has slowed. Because of this, rubber output in recent years has increased less than 1 percent per year. Investment projects now under way, while appearing ambitious, are aimed primarily at maintaining this level of output growth:

- *Thailand* has already successfully implemented its program to replant 160,000 hectares. As a result, industry experts expect output to grow by 20 percent between 1982 and 1985.
- *Indonesia* announced in 1979 a plan aimed at replanting 250,000 hectares in the smallholder sector between 1981 and 1985. Furthermore, Jakarta has recently announced that it will open up new areas to encourage planting of 180,000 hectares on some of the smaller islands. These two programs together could add about 15 percent to Indonesia's rubber output by the early 1990s.
- *Malaysia* has already begun implementing plans that call for some 50,000 hectares of new plantings each year from 1981 to 1985, about double the rate achieved in the 1970s. []

Looking at these programs together, we estimate that after the temporary 4-percent production surge in 1983—caused in large part by intensified tapping in

response to the short-lived commodity price runup early in the year—world natural rubber production is likely to return to about a 1-percent annual rate of growth over the remainder of the decade. While both new plantings and replantings probably will be about 50 percent more productive than the majority of the trees now producing, the net additions to total world rubber acreage will be small—probably less than 5 percent. Indeed, most of the planting must be carried out simply to keep output from declining. []

Institutions

To protect export earnings in the face of declining prices, commodity exporters have traditionally pushed for price and export controls administered through various international commodity agreements. Such has been the case with natural rubber. The International Natural Rubber Agreement (INRA), which came into effect in 1980, is the first in a series of UN-backed commodity agreements designed to raise and stabilize commodity prices and export earnings.³ []

At roughly the halfway mark in the first five years of its scheduled operation, the INRA has experienced more problems than successes:

- Buffer stock purchases have failed to keep prices from falling below the "must buy" band: they have had to be suspended because of a shortage of funds. Members are refusing to give additional money for this purpose, according to trade journal reports.
- The large quantity of rubber already in the official INRA stockpile—about 260,000 tons—is having a depressing effect on the recovery of rubber prices. According to industry reporting, potential buyers fear that if economic recovery is strong enough the price could reach the ceiling level at which the buffer stock manager must begin to sell off stocks.
- Rubber price fluctuations have not been appreciably reduced. In the first three years of the agreement, average yearly fluctuations have been about 25 percent, greater than the average of the last 10 years. []

³ The agreement was ratified by six producing and 22 consuming countries. []

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More important, the key producers cannot agree on the future course of action. According to a Department of the Treasury report, Malaysia, which produces nearly twice as much rubber as its nearest competitor, is pushing for renegotiation of the current agreement, which expires in October 1985. Reportedly, Kuala Lumpur would like to have a new agreement based on production and export controls rather than on a buffer stock. This would serve to guarantee Malaysia its current market share in the face of stagnating output. The same source reports that Indonesia and Thailand, with greater growth potential, are pressing to retain the buffer stock but with higher floor and ceiling prices. []

In our view, these issues will become more hotly contested at future INRA meetings as negotiating positions are prepared for the first UN Rubber Renegotiating Conference, scheduled for June 1984. If anything, the slow pickup in rubber demand will generate further strains. According to estimates by the EIU, natural rubber demand in 1983 probably rose only 3 percent over the depressed level of 1982. Production, however, grew by about 4 percent, boosting world stocks to a new high of about 1.7 million tons, some 45 percent of annual world consumption. []

Technology

In our judgment, natural rubber producers have not fully utilized the production technology at their disposal. Their failure to make wider use of production enhancement techniques to increase efficiency and lower costs has contributed over the years to natural rubber's long-run price disadvantage vis-a-vis synthetics. []

Latex yields could be increased dramatically by planting new varieties of trees. Yields in the producing areas of Southeast Asia range from 500 to 1,200 kilograms per hectare per year. High-yield trees already commercially available could more than double yields to 2,500 kilograms. According to EIU, yields of 7,000 kilograms per hectare per year are possible through greater use of more sophisticated mutation breeding and tissue culture techniques. The low yields at present are caused by the large number of older trees that are still being tapped, the immaturity of newly planted trees, and the slow replanting rate. []

Increased use of chemical stimulants could also increase rubber output. Stimulants are used only on trees more than 15 years old, proving especially valuable on those nearing the end of their productive lives. Ethephon, the most widely used stimulant, has improved yields by as much as two-thirds. Other more effective stimulants are also available. Stimulation can be used either to increase yields while maintaining tapping frequency and intensity or to maintain yields while reducing tapping. The latter permits considerable labor savings. []

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Lessons From the Rubber Experience

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Over the long haul, technology is likely to be the bane of the LDC commodity producers in general. Just as the development of a wide range of inexpensive synthetics has cut sharply into natural rubber's traditional markets, new processes, techniques, and products are displacing other traditional commodities in the marketplace, some at an astonishingly rapid pace. For example:

- The sweetener market has been radically transformed by the introduction of a continuous enzymatic process for mass production of high fructose syrup made from corn (HFCS). Industry analysts predict that HFCS consumption in the United States will have captured 29 percent of the domestic caloric sweetener market by 1985 or 1986. This trend will soon spill over to the other OECD countries, greatly hurting world sugar demand. 25X1
- Optical fibers made of silicon glass are outcompeting copper wire in communications applications because of their greater message-carrying capacity. 25X1
- Composites (fiber-reinforced plastics), single crystal and amorphous metals, and ceramics are displacing traditional materials such as iron and steel, aluminum, cobalt, and superalloys in aircraft and automobile bodies and engines. The technology to build an airframe entirely out of composites has already been demonstrated. The rate at which these exotic materials penetrate the metals market now depends only on their economics. 25X1

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National Production Strategies

Thailand's steady growth in natural rubber production is largely attributable to new plantings. Bangkok has successfully implemented its Accelerated Replanting Project of 1977-80. Under this program, Thai producers replanted 160,000 hectares—25,000 in the first year, 35,000 in 1978, and 50,000 per year in 1979 and 1980. As a result of this aggressive program, industry experts expect production to grow to 700,000 tons per year by 1985, a 25-percent increase over 1982 output. Further replantings later in the 1980s are already called for. The government has announced plans to replant as much as 250,000 hectares. In addition, industry observers expect government land-settlement schemes to open up 16,000 hectares of new acreage by 1985. [redacted]

In addition to the replanting program, Bangkok provides incentives in the form of replanting grants and technical assistance to smallholders, so that they do not switch to other crops when their rubber trees reach very low levels of productivity. The priority given to the rubber sector is reflected in the size of the grants for replanting. According to the Economist Intelligence Unit (EIU), in 1979 the grant stood at M\$2,035 per hectare for rubber, as compared with \$1,089 for other crops. To date, this policy has been effective; only 5 percent of recent replanting has been with other crops. Nevertheless, prospects for continued success will hinge largely on government support for the smallholder sector and the availability of financing. If economic conditions do not pick up substantially, the leadership in Thailand will probably cut back on aid to natural rubber producers. [redacted]

Indonesia announced in 1979 a seven-year plan aimed at replanting 300,000 hectares in the smallholder sector—20,000 in 1979, 30,000 in 1980, and 50,000 per year in 1981-85. Under the program, the

government covers 35 percent of the costs, with the remainder financed by loans from the World Bank. Smallholders receive a replanting grant of \$1,200 per hectare, and the government funds its contribution from a special tax on natural rubber exports. [redacted]

Indonesia has also announced that it will open new areas to rubber cultivation. According to recent government statements, the intention is to broaden the natural rubber base by encouraging plantings of 180,000 hectares on some of the smaller islands. This strategy is not confined to natural rubber but embraces a number of other crops. It is being carried out in conjunction with the transmigration program, designed to resettle some one-half million families. Some new planting is also envisaged on existing smallholdings, for which the World Bank has extended an additional \$5 million loan. [redacted]

Indonesia is currently feeling the impact of reduced replantings in the past. Production growth over the next few years will be sluggish at best. Moreover, yields are the lowest of the big three producers; according to EIU statistics, yields in Malaysia, for example, are about 80 percent higher than in Indonesia. Yields on small farms, which account for about two-thirds of Indonesia's rubber output, are particularly low, and productivity is expected to continue to decline. There will probably be a decline in production from these farms until 1985, when the payoff from current government programs starts. There could, however, be a small spurt in total output this year as higher prices for natural rubber encourage some increased tapping. Declining or stagnating oil and gas revenues—which accounted for three-fourths of Indonesia's export earnings last year—will place increased strains on domestic spending. This, in turn,

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could jeopardize the success of Indonesia's rubber project. []

Malaysia's rubber production policy is currently aimed at accelerating output, based on replanting with high-yielding trees and on land development schemes to increase acreage. Kuala Lumpur has already begun implementing plans that call for some 50,000 hectares of new plantings per year from 1981 to 1985, about double the rate achieved in the 1970s. []

Other measures currently in effect to encourage production include: a redress of the imbalance of the export duty on rubber, as compared with competing crops; the creation of a credit fund for smallholders to foster wider adoption of research innovations; the creation of a plantation development corporation to assist government agencies in developing new rubber estates on a commercial basis; and an intensification of rubber research and development through the Malaysian Rubber Research and Development Board. []

In response to depressed prices, changing rubber consumption patterns, and austerity budgets, Kuala Lumpur has begun to review its rubber policies. Datuk Paul Leong, Minister of Primary Industries, recently announced the formation of a review committee that will look into supply and demand in the rubber market over the next two decades. If Leong's public statements are any guide, the group will recommend how much land and capital Malaysia should devote to rubber cultivation. Given the severe labor shortage in Malaysia and the government's determination to pursue a capital-intensive industrialization policy, the rubber industry is likely to become less important to Malaysia's economy in the years ahead. []

- Manmade fibers have revolutionized the markets for thread, cloth, yarn, carpeting, and upholstery. DuPont's improvements in polyesters in the 1950s—as well as in nylon, aramids, acrylics, and modacrylics—have led to major inroads in the markets for traditional cotton, wool, and silk fibers. From only 2 percent in the 1950s, manmade fibers rose to 44 percent of total world fiber output in 1982. In the United States, synthetics now hold 75 percent of the overall textile market. The easing of oil prices will help keep synthetics cost competitive. []

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The LDCs, in response to this technology onslaught, have continued to push for commodity agreements incorporating price controls, buffer stocks, quotas, and other market-sharing devices, not only in rubber but in most commodities. Under the aegis of the UNCTAD Integrated Program for Commodities, the LDCs hope eventually to bring 18 key commodities under some form of control, financed by a \$6 billion Common Fund. While the International Natural Rubber Agreement is the only commodity agreement established through UNCTAD's efforts, talks and negotiations are continuing for cotton, hard fibers, jute, tea, tropical timber, bananas, and bauxite. []

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The INRA problems serve to illustrate some of the deficiencies of all commodity agreements. These include:

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- Direct cost—industry specialists estimate, for example, that a 500,000-ton buffer stock would be needed to defend a 10-percent price band for rubber. At 50 cents per pound, the cost would be more than \$550 million.
- Inefficiency—commodity agreements that rely on quotas based on historical production or export averages to allocate market share tend to penalize new, more efficient entrants into the market.
- Indirect cost—since the effect of most commodity agreements is to raise the long-run average price above what it would otherwise be, they raise the cost to all consumers of products using the controlled commodity. []

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The Threat From Technology

The near monopoly position enjoyed by natural rubber in the first half of this century was effectively dissolved by the rapid introduction of synthetic rubber since World War II. The United States, cut off from its main sources of natural rubber in Southeast Asia during the war, launched a crash synthetic rubber development program in the mid-1940s. Renewed fears of rubber shortages during the Korean war stimulated a technological breakthrough—cold polymerization—in the production of synthetic styrene-butadiene rubber (SBR), which made it technically and economically competitive with natural rubber. SBR is now the dominant rubber used.

While natural rubber is preferred in uses where heat and cracking resistance, tensile strength, and adhesion to metal surfaces are important, these uses account for only 20 percent of the total rubber market. Synthetic rubber's properties make it preferred in 30 percent of rubber's applications, leaving about one-half of the market to be allocated on the basis of price comparisons. Natural rubber's current market share is about 30 percent, having fallen from nearly 70 percent in 1950.

From about 1950 to the early 1970s, synthetic rubber prices fell steadily as a result of technological breakthroughs, economies of scale, and stable oil prices. As synthetic rubber became progressively more important in world markets, its price held down the price of natural rubber. Since at least the early 1970s, syn-

thetic rubber has been cheaper than natural rubber (figure 2). The gap has been as much as 40 cents per pound at times and currently is 15 cents per pound.

This price advantage was thought by natural rubber producers to have ended when synthetic rubber prices surged past natural rubber prices in late 1974 as a result of the first oil shock. These hopes were short lived, however, as recession cut back natural rubber consumption while inflation in the form of sharply higher wages boosted production costs.

The dependence of tire manufacturers on synthetic rubber encouraged them to integrate backward into the rubber industry, whereas the similarity between the technical processes of synthetic rubber production and those of petrochemical production offered chemical producers a considerable incentive for forward integration. Tire manufacturers and petrochemical producers, therefore, now dominate the production of synthetic rubber outside the centrally planned economies. The petrochemical industry alone appears to control more than 50 percent of the existing production capacity of synthetic rubber in the developed West, and the tire manufacturing industry owns another 40 percent. As a result of this captive production capacity, many manufacturers have a great incentive to use synthetic rubber wherever possible.

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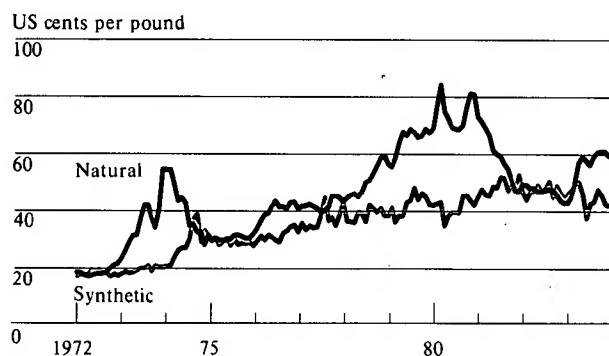
With no viable alternatives, the LDCs are stuck with pushing a failed policy. For most producers, the costs—both economic and political—of shifting from raw materials with a dim future are simply too high, especially given their current financial bind. Moreover, any adjustments would come at a time when governments in the debt-troubled LDCs are being asked by the IMF to tighten their belts until they can get their economies more in order.

Within this framework, US policymakers will be challenged by frequently conflicting goals. While US support for additional multilateral commodity agreements might ease LDC earnings problems in the short run—and could be done in many cases at relatively low cost—such policy actions would perpetuate the

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Figure 2
Rubber Prices, 1972-83



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basic problem of most commodities—excess supply. Indeed, the situation will only worsen as technology shifts demand away from basic commodities and raw materials.

Eventually, the LDCs will have to begin the painful steps to restructure their economies. Although we doubt they will give up entirely on their push for commodity agreements, LDCs will primarily be seeking US support in the form of development financing and market access for the products they produce in place of commodities. When that time comes, the nature of the challenges for US policymakers will change, providing opportunities to influence the direction of the restructuring.

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